

Annual letter to the co-investors of SIH BrightGate Global Income Fund

January 10th, 2022, Madrid

“Whenever a man does something perfectly stupid, he does it for the noblest of reasons.”

Oscar Wilde, the picture of Dorian Gray

Dear co-investors,

First, we hope that you and your loved ones are keeping safe and healthy. BrightGate Capital sends a warm hug to all of you during these difficult times.

We would like to start with a quick summary of the fund. The fund closed on 31st December 2021 with a NAV of 129.0, which represents a net annual return of 8.47%. The fund was launched on 14th October 2013, and the annualized return since inception has been 3.1%. The ISIN codes for the different share classes of the fund are LU0942882589 (class A) and LU1984948874 (class F).

The philosophy of the fund is Buy & Hold, with an investment mandate in global credit with low durations, generally below 3. The portfolio is currently relatively concentrated, between 40 and 45 positions, and gathers our best ideas, which we believe offer a more attractive risk-adjusted return than the average credit found in today’s High Yield (HY) markets. Although we prefer to hold the positions for as long as we can, our fund in this respect is not a traditional Buy & Hold fund, where positions are bought and held until maturity. Nonetheless we constantly assess our positions against the price at which they are quoted and the performance of their business fundamentals. In the current climate of narrow credit spreads and low interest rates, we believe that traditional Buy & Hold strategies are poor candidates for any investor’s portfolio, given that elevated valuations make it difficult to reinvest coupons, and interest payments are used to buy increasingly expensive bonds. We believe that the correct reinvestment of coupons is an important, and very often unappreciated, source of long-term profitability; our investors can be assured that a large amount of our attention is committed to this task.

Regarding the currency hedging policy, the portfolio was completely hedged at the end of the year. We do not expect changes in the hedging policy for 2021. Now, we will review the year of 2021, share our views on the markets, and walk you through our main positions for this year of 2022.

A few thoughts on 2021

In last year's letter we mentioned three lessons that we had learned during the pandemic and that we hope to apply to the Fund's management philosophy from now on, namely: increased portfolio concentration, improved average credit quality of holdings, and greater flexibility when it comes to taking duration risk. Although we haven't increased duration during the year, we think the performance attribution has anchored over the first two points. We do not want to sound advantageous, and we understand that a year is a short time for any resounding evaluation, but we do consider it to be a good starting point.

As a summary of what the year has been and to frame future return expectations correctly, we would like to share with you the following metrics. As of January 1st, 2021, the Fund had a YTW (in euros) of 6.6%, with a duration of 2.7. As of the end of the year, had a YTW of 5.8% and a duration of 2.3, and the total return for the year (which already includes management fees) was 8.5%. Then, what explains this difference of 6.6%? (Before management fees), which is what our investors could expect at the beginning of 2021, compared to the 8.5% that we finally obtained? Basically, three factors. First, credit spread compression, which are reflected in the lower YTW at the end of the year and considering that our duration has been constant. Second, we have had a zero-default rate during the year, well below the indices, which in turn have shown historically low rates and which we do not believe are bearable in the future. And third, we have added profitability, with specific events (such as the strong revaluation on our Turning Point Brands convertibles) and with energy bonds we have added throughout the year that have experienced significant appreciation.

In summary, although the YTW is an excellent metric of what our investors can expect in the long term, the divergences that commonly occur in any given year between this metric and the performance can be quite significant. While we obviously cannot know what the next few years will hold in terms of returns, we are certain that we will continue to do better than global high yield fixed income indices and most of our competitors.

Commentary on main positions

Going into more detail on the composition of the portfolio, the percentage invested is slightly lower compared to the end of the previous year, due in large part to the higher valuations and the lack of attractive opportunities in the credit markets.

At the risk of sounding repetitive, we continue to believe that current valuations, in both fixed income and equities, are unparalleled in history, resulting in mediocre medium- and long-term returns. As we mentioned in the previous section, the only sectors in today's fixed income indices that we believe continue to provide an acceptable return are those affected by some type of ESG exclusion and, to a lesser extent, some specific emerging markets bonds. It is in these two niche markets, as well as in preferred stocks and convertible bonds, where we have dedicated our efforts to generate ideas this coming year.

Below, we detail the main investments of the Fund at the end of the year, ordered by portfolio weight. We have grouped some of them by theme, as we believe it facilitates the global understanding of the portfolio. Given that the portfolio turnover during the year has been the lowest in the history of the Fund, most of our main positions were in our portfolio at the end of last year, so we invite our investors to read this section together with last year's letter to improve insight into how these businesses are performing:

- Energy infrastructure (Teekay LNG, Enbridge, Brooge Energy, PBF Logistics, Peru LNG, Blueknight Energy, Golar LNG):** among these businesses, the fund has the highest exposure by theme, 18%, and only Enbridge individually exceeds the 3.5% by weight. This set of businesses makes up the heart of our portfolio thanks to its combination of acceptable returns, good balance sheets, long-term earnings visibility, and short-term tailwinds. During this year we sold our position in Navigator Gas above par, as the refinancing of the bond was close, and we switched into Golar LNG (a business similar to Teekay LNG but also operating floating liquefaction units) and the preferred shares of Blueknight Energy, which after a deep corporate reorganization has become a company that exclusively operates asphalt storage terminals, a business with a long history of attractive returns. Although the dynamics of each of these companies throughout an economic cycle are very different from each other, since the transport of liquefied natural gas has nothing to do with the storage of crude oil, all these businesses share two characteristics. First, they operate irreplaceable assets, with long useful lives and high entry barriers (there is little point in building a new pipeline next to an existing one if there is no additional demand to justify it). Second, these assets operate under medium / long-term contracts, improving our visibility of the business as bondholders. Most of these companies have continued to improve their balance sheets during 2021 given their constant cash generation (in the case of Brooge Energy, thanks to the new crude storage terminal they have recently started to operate) and, in those businesses related to the chain supply of liquefied natural gas, thanks to the increase in the price differentials of liquefied natural gas in different geographies.
- Oil producers (Siccar, Okea, DNO, GKP, Waldorf, Ping, Petrotal):** Like last year, we have a significant exposure to oil producers, which represents around 12.6%, and is distributed among seven issuers. We have increased our exposure to this group as visibility in the recovery of oil demand has become more evident. One might think that the price we have paid for this "certainty" has been through the purchase of credits with less attractive returns to maturity, but surprisingly this has not been the case. The entry of small issuers that had never approached to credit markets before, added to the headwinds produced by the ESG exclusions, has made energy primary issuers very attractive this year. As an example, we have the cases of Waldorf and Ping, both companies with assets in the North Sea (characterized by being a proven geography, with low geological risks, and operating with low costs that become profitable at Brent prices over \$ 50). Both companies made their inaugural issuance paying coupons above 10% and slight discounts over par value. These two companies have low debt levels and reasonable production capacity expansion plans. With current oil prices, both producers would deleverage their balance sheets in less than two years. This is also the case of Siccar and Okea, investments that we have been maintaining since 2019 and that have behaved according to our predictions.
- Thermal coal (Alliance Resource / Consol Energy / Wilpinjong Mine):** 2021 has been an extraordinary year for our investments in thermal coal, not only due to the strong appreciation in prices of the Alliance and Consol bonds but also due to the robust evolution of the industry fundamentals. Although the yield on bonds is not as cheap as a year ago, we have maintained both positions since the opportunity is still very attractive, with yields to maturity above 7% in euros and low gearing

balance sheets. During 2021 we have modestly increased our exposure to thermal coal through the purchase of Wilpinjong mine's bonds, an open pit mine in Australia owned by Peabody, and one of the crown jewels of this company. The bond is the result of the difficulties that Peabody experienced in the past to refinance debt and extend maturities, having had the obligation to collateralize their most valuable Australian assets (the mines from Peabody in the US are in the Powder River Basin, which is characterized by a poorer quality coal sold at low prices due to transportation issues). The bond continues to pay yields close to 10%, and we believe that its cash sweep provides additional protection to bondholders by allowing early redemption. 2022 will presumably be another financially robust year for these three issuers, since a large part of the production of these companies is already sold at higher prices than those made in 2021.

- **Turning Point Brands:** After accounting for 5.6% of the portfolio at the end of last year (the largest position we have ever had in a single position in the fund), we have reduced our exposure to Turning Point Brands (TPB) at the beginning of the year by half, after convertible bonds experienced a strong appreciation and began to trade with negative yields to maturity. Although our investment policy does not prevent us from holding these instruments with an attractive underlying history and exploiting their upside potential, we thought it was a prudent decision (at that time) to reduce our exposure, while we believe that the growth opportunity for TPB in the next three years is still very appealing. As a reminder, the North American TPB is dedicated to the manufacture, marketing, and distribution of tobacco products, specifically rolling paper (through the iconic Zig-Zag brand) and chewing tobacco, a product in which it operates in the low-cost segment, compared to its biggest competitor, Altria. Since the 1990s, pricing in the US tobacco sector has been extremely rational, years in which the war price ended, and Altria assumed the role of the price-fixing leading company. Ever since, Altria has consistently increased prices every year on traditional cigarettes, in the range of 6-10%. These dynamics of conventional tobacco will favour the chewing tobacco segment (which, although it has not had such robust price dynamics, has remained favourable), which is where TPB operates with its most affordable products competing with Altria brands named with Skoal and Copenhagen. Third quarter results have penalized the company's shares (and therefore convertibles) due to high market expectations, even though we considered them quite solid. We hope to take advantage of any weakness in the price to increase our position again.
- **Aimia:** Aimia is a well-known business in which we have been invested since 2017. We haven't made any changes position during 2021. After the events of 2020 (which we explained in detail in last year's letter), the company has become a holding company, whose main asset continues to be Club Premier (although we expect a sale in the short term, once the Aeromexico's business after exiting the bankruptcy in which it has been involved the last year) as well as a set of smaller investments devised by Christopher Mittleman, a globally recognized value investor. While we believe there is a strong likelihood that Mittleman will continue to create value for Aimia shareholders in the years to come, the opportunity for us as shareholders of its preferred shares is objectively worse than what we have been enjoying since 2017, due to higher prices and greater risk involved in said investment program. We do not

rule out cutting down our position in the preferred in the coming months if the shares price continues to climb towards its par value.

- **Fannie Mae y Freddie Mac:** although our combined position in the GSEs (*government-sponsored enterprises*) is very low after last year's sharp declines, we think it is interesting to provide a brief update on the investment thesis. It is fair to say that the thesis is well behind what we were expecting some years ago, and the events of 2021 have accentuated such negative dynamics. In June, the US Supreme Court of the US basically agreed with the US government on the expropriation that the GSEs (and their shareholders) have suffered under the successive Bush, Obama, and Trump administrations. Although the Supreme Court admitted the unconstitutionality of the FHFA Director (which led to the dismissal of the then-director Mark Calabria), such a win has been pyrrhic and clearly insufficient for a successful legal outcome of the investment. Another unfavourable event during 2021 was the appointment of Sandra Thompson as new FHFA Director, a relatively incompetent bureaucrat in our opinion, one of whose first measure has been to "amend" Calabria's capital rule introduced earlier in the year, which was based on ideological prejudices and heavily penalised the GSEs' balance sheets, putting them at the same level as that of a bank. It seems that both Calabria and Thompson have been unable to interpret the latest stress tests on Fannie and Freddie, which confirmed that the GSEs' balance sheets have been fully cleaned and that a repetition of the events of 2008 was off the cards. It is worth remembering that the business of the GSEs has been crucial for the correct working of the US mortgage market during the pandemic, and it has been extremely profitable as well. However, the collection of incompetent bureaucrats that populate the US government entities, together with the goals of the banking lobby, which is seeking to cripple Fannie and Freddie's capabilities when insuring mortgages, make the resolution of our investment most uncertain than ever.

Concisely, the fund has a YTW (in euros) of 5.8% and a duration of 2.3. We believe that these metrics will continue to allow us to outperform our competitors in 2022 and provide us with the flexibility for potential opportunities that may arise throughout the year.

We are at your entire disposal to answer any questions that may appear or to go into detail in any name in the portfolio.

Sincerely,

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